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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-560

BLYTH, EASTMAN DILLON & CO., INC.,
and MICHAEL STOTT,

Petitioners,

v.

DAVID E. ROLF,

Respondent,

and

AKIYOSHI YAMADA,

Defendant.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

MOTION FOR LEAVE TO FILE BRIEF *AMICI CURIAE* AND BRIEF *AMICI CURIAE* OF MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, SHEARSON HAYDEN STONE INC. and SECURITIES INDUSTRY ASSOCIATION, INC. IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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MOTION OF MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, SHEARSON HAYDEN STONE INC. and SECURITIES INDUSTRY ASSOCIATION, INC. FOR LEAVE TO FILE BRIEF *AMICI CURIAE* IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), Shearson Hayden Stone Inc. ("Shearson") and Securities Industry Association, Inc. ("SIA"), hereby respectfully move pursuant to Rule 42 of this Court for leave to file the attached brief *amici curiae* in support of the petition for a writ of certiorari. The consent of the attorney for petitioners has been obtained. The consent

of the attorney for the respondent has been requested but refused.

Merrill Lynch and Shearson are two of the largest broker-dealers in the United States. Both Merrill Lynch and Shearson operate on a nationwide basis through an extensive network of branch offices in which their brokers service customer accounts, including those under the control of investment advisers, which advisers place orders with respect to the portfolios which they manage for clients of these firms.

The SIA is a national trade asscociation which was formed in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers Association of America. The SIA has approximately 474 broker-dealer members doing business throughout the United States. That membership is responsible for over 90 percent of the securities brokerage business of the nation and both includes members of national securities exchanges and firms which are not members of such exchanges. SIA's members populate all sectors of the securities industry, servicing investors of every size and type and performing the entire range of securities activities, including retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, various exchange floor functions, and money management and investment advisory services. As a consequence, the SIA is generally recognized as a spokesman for the securities industry to the public and to the Government.

Given the foregoing, Merrill Lynch, Shearson and the SIA are acutely interested in the nature and scope of a broker's legal duties with respect to accounts managed by

independent investment advisers. They strongly believe that the majority opinion of the United States Court of Appeals for the Second Circuit below in *David E. Rolf* v. *Blyth Eastman, Dillon & Co., Inc., et al.*, 570 F.2d 38 (2d Cir. 1978), may have a substantially adverse impact on the nature of the relationship between brokers and investment advisers which relationship is of paramount importance to both Merrill Lynch and Shearson individually, and to the SIA and its membership in an industry-wide basis.

In addition, because the Second Circuit below expressly decided significant questions of federal law not yet considered by this Court, which in the opinion of *amici* conflict with Court's opinion in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), Merrill Lynch, Shearson and the SIA urge that this Court review this holding.

All three *amici* believe that the rule of law laid down by the Second Circuit panel as regards the relationship between brokers and investment advisers needs to be presented as part of this Court's review of this case. If, as the Second Circuit contends, a broker can be held liable as an aider and abettor under Section 10(b) and Rule 10b-5 simply by reason of (1) the execution of transactions in allegedly "unsuitable" securities, directed by an investment adviser with sole discretionary authority, and (2) the expressions of confidence in such adviser, based on such adviser's then excellent reputation, then the entire nature of the relationship between brokers and investment advisers will become unworkable.

The Second Circuit below permitted Merrill Lynch, Shearson and the SIA to file briefs *amicus curiae* in support

of petitioner's application for rehearing with suggestion for rehearing in banc. Merrill Lynch, Shearson and the SIA believe that their substantial interest and exposure to problems relevant to stock brokerage firms in general should be sufficient to allow them to participate in the ultimate resolution of this significant case before this Court.

WHEREFORE, the undersigned respectfully move this Court that they be granted leave to file the annexed brief *amici curiae.*

Respectfully submitted,

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BRIEF *AMICI CURIAE* OF MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, SHEARSON HAYDEN STONE INC. and SECURITIES INDUSTRY ASSOCIATION, INC.

Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), Shearson Hayden Stone Inc. ("Shearson") and the Securities Industries Association, Inc. ("SIA") respectfully pray that this Court grant a writ of certiorari to review the opinion and judgment of the Court of Appeals for the Second Circuit entered on January 3, 1978, as amended by an order dated May 22, 1978.

Interest of *Amici Curiae*

Merrill Lynch and Shearson are two of the largest broker-dealers in the United States. Both Merrill Lynch and Shearson operate on a nationwide basis through an extensive network of branch offices in which their brokers service customer accounts, including those under the control of investment advisers, who place orders with respect to the portfolios which they manage for clients of these firms.

The SIA is a national trade association which was formed in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers Association of America. The SIA has approximately 474 broker-dealer members doing business throughout the United States. That membership is responsible for over 90 percent of the securities brokerage business of the nation and includes members of national securities exchanges and firms which are not members of such exchanges. SIA's members populate all sectors of the securities industry, servicing investors of every size and type and performing the entire range of securities activities, including retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, various exchange floor functions, and money management and investment advisory services.* As a consequence, the SIA is generally recognized as a spokesman for the securities industry to the public and to the Government.

Given the foregoing, Merrill Lynch, Shearson and the SIA are acutely interested in the nature and scope of a

broker's legal duties with respect to accounts managed by independent investment advisers. They strongly feel that the majority opinion of the United States Court of Appeals for the Second Circuit below in *David E. Rolf* v. *Blyth Eastman, Dillon & Co., Inc., et al.*, 570 F.2d 38 (2d Cir. 1978), will have a substantially adverse impact on the nature of the relationship between brokers and investment advisers which is of paramount importance to both Merrill Lynch* and Shearson individually, and to the SIA and its membership on an industry-wide basis.

All three *amici* believe that the rule of law laid down by the Second Circuit majority as regards the relationship between brokers and investment adivsers represents the establishment of a significant new tenet of federal securities law which only this Court should create. If a broker can be held liable as an aider and abettor under Section 10(b) and Rule 10b-5 merely by executing transactions in allegedly "unsuitable" securities, directed by an investment adviser with sole discretionary authority, and by expressing confidence in such adviser, based on such adviser's then excellent reputation, then the entire nature of the relationship between brokers and investment advisers will become unworkable. Since Merrill Lynch, Shearson and the SIA firmly believe that such conduct is insufficient as a matter of law to establish aider and abettor liability based

* Merrill Lynch is also presently a defendant in an action now pending in the United States District Court for the District of Maryland entitled *Lillian F. Kaufman, et al.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., et al.* (Civil Action No. B76-227), where issues similar to those raised in *Rolf* are at issue. Resolution of *Rolf* is of immediate concern to Merrill Lynch, in that a final determination of this action might have a substantial impact on the aforementioned action as well.

upon this Court's holding in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) [hereinafter "Hochfelder"], they feel that this Court should accept this case for a full review.

Argument

The majority of the Second Circuit seeks to impose aider and abettor liability on a registered representative and his broker-dealer employee under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 thereunder, 17 C.F.R. §240.10(b)-5, for trading losses (including losses with which the registered representative had no connection*) suffered by an investor as a result of the purchases and sales of allegedly "unsuitable" securities in discretionary accounts managed by an independent investment adviser.** The majority further asserts that although an investment adviser directs all of the trades based on a written trading authorization, the broker-dealer still owes the customer a fiduciary duty. Finally, the majority concludes that the requisite *scienter* for aiding and abetting liability under Section 10(b) and Rule 10b-5 may be satisfied by a claimed "reckless" endorsement of the investment adviser's competence, even though such aider and abettor does not have actual knowledge of the underlying fraud.

* 570 F.2d at 49; A22 ("A" refers to the Appendix to the Petition).

** The majority later amended its opinion by Order dated May 22, 1978 (see A39-40) which added footnote 16A to the opinion. That footnote sought to exculpate any "broker-dealer who merely executes orders for 'unsuitable' securities made by an investment advisor vested with sole discretionary trading authority to control the account." *Id.* This does not vitiate the original opinion's holding that a broker-dealer is liable because he "either failed to learn of or failed to disclose [the investment advisor's] web of fraud." 570 F.2d at 48; A18.

Merrill Lynch, Shearson and the SIA believe that these determinations are significant* because they attempt to establish new standards as regards the legal duties of brokers to independently-managed account customers which are not, we believe, in keeping with this Court's determination in *Hochfelder* and other equally well established principles of federal and state law relevant to these issues.

Merrill Lynch and Shearson are in continuous contact with literally hundreds of investment advisers and money managers. The SIA represents both brokers and money managers on an industry-wide basis, so that any judicial alteration of their working relationship is of great concern. There are innumerable situations where Merrill Lynch, Shearson and other SIA members deal with other parties

* The majority opinion has been referred to in over 20 reported decisions since January, 1978. In addition, the majority opinion is viewed by some as undermining this Court's holding in *Hochfelder*. The *amici* are aware of at least one case in the United States District Court for the Southern District of New York where the original determination, made prior to the Second Circuit's decision, dismissing a Rule 10b-5 action brought against an alleged aider and abettor on the basis that, under *Hochfelder*, plaintiff failed to show that the alleged aider and abettor "knowingly participated in the fraudulent scheme," was subsequently challenged and reopening of the judgment sought on the grounds that *Rolf* "significantly modified [the Second] Circuit's application of the concepts of scienter, aiding and abetting and broker's liability to his customer under §10(b)" (Affidavit of S. Pitkin Marshall, sworn to March 31, 1978, submitted with Notice of Motion dated April 4, 1978), and "held that even in the face of the *Hochfelder* case, reckless conduct may in some circumstances satisfy the scienter requirement." (Memorandum of Law submitted April 4, 1978 in support of Motion for Relief under F.R.C.P. Rule 60(b)). *Seaboard Leverage Fund* v. *Neuberger & Co., et al.*, 73 Civ. 1759, (Gagliardi, D.J.) See also unreported decision dated October 26, 1977, and Memorandum Endorsement dated September 25, 1978, denying Rule 60(b) Motion on grounds that it was untimely filed. The possibility that other pre-*Rolf* decisions based on *Hochfelder* may similarly be challenged, strongly suggests that this Court undertake a full review of the *Rolf* holding to insure continuity and consistency in this area of federal securities law.

fully authorized to trade for a customer, situations involving pension and retirement funds, mutual funds, insurance companies, executors and bank trust departments. If, as the Second Circuit has apparently held, securities brokers are to be held liable under Rule 10b-5 for a breach of a fiduciary duty in failing to determine the suitability of certain securities for a customer or to monitor the actions of the person or organization chosen by the customer to make investment decisions, then the fundamental nature of the relationship between brokers and customers in this context will become unmanageable. We believe, therefore, that this holding is legally unsound on several grounds.

First, merely the existence of a fiduciary relationship is not sufficient to establish 10b-5 liability absent actual *scienter*. As this Court so appropriately stated in *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 472-474 (1977):

> "To the extent that the Court of Appeals would rely on the use of the term 'fraud' in Rule 10b-5 to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction, its interpretation would, like the interpretation rejected by the Court in *Ernst & Ernst*, 'add a gloss to the operative language of the statute quite different from its commonly accepted meaning.' *Id.*, at 199."
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> * * *
>
> "The claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 *only if* the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute." (emphasis added throughout unless otherwise indicated.)

Next, the majority, having failed completely to define the primary fraud committed by Yamada against Rolf

other than describing it as an "exhaustive and all-encompassing web of fraud" (570 F.2d at 47; A16), proceeded to apply an erroneous concept of "recklessness" which closely resembles the negligence standard specifically rejected by this Court in *Hochfelder* as being insufficient to establish liability. As Judge Mansfield in his dissent properly concluded:

> "The majority views Yamada's investment of the account in unsuitable securities as fraud in and of itself and Stott's state of mind as recklessness amounting to a deliberate intent to deceive. All of this is too much for me to accept. The majority not only patches together watered-down notions of fraud and scienter in arriving at a result indistinguishable in any significant respect from that reversed by the Supreme Court in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.E.2d 668 (1976), but also overlooks findings below and undisputed evidence that foreclose Rule 10b-5 liability." (570 F.2d at 50; A24).

In fact, the *amici* seriously question whether "recklessness" could ever be sufficient to satisfy the *scienter* requirement where aider and abettor or other forms of secondary liability are involved.

Third, as Judge Mansfield notes above, the majority held that transactions in "unsuitable" securities were fraudulent, such that "knowledge" of those transactions, together with certain negligent conduct, was sufficient grounds for Rule 10b-5 liability. Given the vast numbers of securities of various types and qualities in this country, and the infinite variety of customer investment objectives, coupled with an equal divergence of expert opinion as to the merits of such securities, the concept of "unsuitability"

becomes wholly amorphous. Securities such as Equity Funding, Penn Central, Franklin National Bank and W. T. Grant were all at one time highly regarded—yet in hindsight, after their demise, less favorable views were instantly in vogue. A broker must be entitled to rely on independent investment advisers unless and until he has *actual knowledge* of such parties' wrongdoing.* Alternatively, if recklessness is to be permitted to satisfy the *scienter* requirement under Rule 10b-5, then that standard must be sufficiently stringent so as to avoid the problem which the Seventh Circuit corrected in *Sanders* v. *John Nuveen & Co., Inc.*, 554 F.2d 790 (7th Cir. 1977), after that case was remanded by this Court subsequent to *Hochfelder* (425 U.S. at 929).

Judge Mansfield succinctly summarized the problem created by the instant decision when he stated that:

> "to hold that investment of a customer's account in unsuitable securities constitutes §10(b) fraud and that a broker who executes orders given by an investment adviser pursuant to his discretionary authority may be held liable as an aider and abettor of such fraud, places an extraordinary and unconscionable burden on both the adviser and the broker." 570 F.2d at 55-56; A36.

Merrill Lynch, Shearson and the SIA believe that this added burden and enormous potential for liability may well disrupt the existing working relationship between

* Applicable New York state law, although rejected by the District Court below, strongly affirms that brokers are not culpable for misconduct by those invested with a discretionary power of attorney. *Morris Rosen* v. *Dudley Harde et al.*, 238 A.D. 622 (1st Dept. 1933). See also *Carroll* v. *Doolittle*, 191 N.Y.S.2d 388 (Sup. Ct. Niagara Co. 1959); *Bischoff* v. *Yorkville Bank*, 218 N.Y. 106, 191 N.Y.S.2d at 400-01 (1916).

brokers and independent investment advisers, to the clear detriment of investors. This is of such importance that this Court should grant the petition.

Conclusion

For the foregoing reasons, as well as those set forth in the petition, Merrill Lynch, Shearson and the SIA respectfully urge that the petition be granted so that this Court can consider important questions arising under the federal securities laws.

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